COMMISSION ON STATE TAX AND FINANCING POLICY

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MEETING MINUTES[1]

Meeting Date:	**August 10, 2000**
Meeting Time:	**2:00 P.M.**
Meeting Place:	**State House, 200 W. Washington St., Room 404**
Meeting City:	**Indianapolis, Indiana**
Meeting Number:	**1**

Members Present: **Rep. B. Patrick Bauer, Chairperson; Rep. Vern Tincher; Rep. Lawrence Buell; Sen. Lawrence Borst; Sen. Vi Simpson.**

Members Absent: **None.**

Representative B. Patrick Bauer, Chair of the Commission, convened the meeting shortly after 2:00 P.M. After introducing the Commission members, Representative Bauer briefly described the study topics that were assigned to the Commission by the Legislative Council.

I. Taxation of Electronic Commerce

Representative Bauer recognized Senator Lawrence Borst, a member of the Commission, for a discussion of proposals from the National Conference of State Legislatures (NCSL) and the National Governors Association (NGA) concerning the streamlining of sales and use tax collection.

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[1] Exhibits and other materials referenced in these minutes can be inspected and copied in the Legislative Information Center in Room 230 of the State House in Indianapolis, Indiana. Requests for copies may be mailed to the Legislative Information Center, Legislative Services Agency, 200 West Washington Street, Indianapolis, IN 46204-2789. A fee of $0.15 per page and mailing costs will be charged for copies. These minutes are also available on the Internet at the General Assembly homepage. The URL address of the General Assembly homepage is http://www.ai.org/legislative/. No fee is charged for viewing, downloading, or printing minutes from the Internet.

Senator Borst described the *Bellas Hess* and *Quill* cases, which prohibit a state from requiring the collection of sales and use tax by remote sellers that do not have sufficient nexus with the state. Senator Borst stated that with the growth of sales over the Internet, Indiana would lose additional sales and use tax revenue, although it was uncertain how much would be lost.

He then explained that he is a member of the NCSL committee that is exploring ways in which the sales tax collection process could be streamlined. Senator Borst said that the NCSL and the NGA have devised a plan under which merchants could voluntarily participate in a sales and use tax collection process in which a third party would calculate, collect, and remit sales and use tax. Under such a plan, participating retailers would be relieved of their sales and use tax collection duties, and the third party responsible for those duties would be reimbursed in a manner similar to credit card transactions. He emphasized that this would not involve imposing new taxes, but would instead facilitate the collection of taxes that are due on sales transactions under existing laws.

Senator Borst noted that the United States Congress had appointed a commission, the Advisory Commission on Electronic Commerce, to study issues related to the taxation of electronic commerce. Senator Borst commented that he believes a number of the members of the federal commission were clearly opposed to proposals that would assist states in collecting sales and use tax on remote sales. He also stated that a number of bills concerning the taxation of electronic commerce have been introduced in Congress, including one proposal that would extend the moratorium provisions of the Internet Tax Freedom Act for an additional five years.

Senator Borst also stated that four states are preparing to implement the NCSL / NGA proposal on a trial basis. He said that he hopes Indiana passes the model legislation to allow it to participate in the sales tax streamlining program.

Chairman Bauer then recognized Professor John Mikesell, Professor of Public Finance and Policy Analysis at Indiana University. Professor Mikesell began by distributing to Commission members written testimony and a number of articles related to the taxation of electronic commerce. (See Exhibit A, "State Taxation and Electronic Commerce: A Review of Some Critical Issues;" Exhibit B, "Simpler Sales Tax for Remote and Local Vendors;" Exhibit C, "The Commission, Sales Tax Streamlining, and Physical Presence: More Observations on the Internet Battlefield;" and Exhibit D, "Electronic Commerce Over the Internet: Emerging Opportunities and Increasing Confusion.")

Professor Mikesell testified that while the sales and use tax revenue loss from remote sellers engaging in electronic commerce is relatively small, it is growing. He said that by fiscal year 2003, the state may be losing as much as $325 million per year, or five percent to seven percent of sales tax revenue at that time.

Professor Mikesell explained that under the *Quill* decision remote sellers who <u>do</u> have some physical presence in the state are required to collect and remit sales and use tax, while those remote sellers who <u>do not</u> have an in-state presence cannot be required to collect the tax. He stated that if a remote seller does not have a physical presence in the state, the state must then either attempt to collect the tax from the purchaser or convince the seller to voluntarily agree to collect the tax, even though the seller cannot be forced to do so.

Professor Mikesell then described to the Commission nexus issues involving an out-of-state electronic seller that is affiliated with a merchant that has an in-state physical presence. He stated that under existing laws and judicial interpretations, the remote seller is viewed as a separate entity from the in-state seller, and the remote seller is not held to have nexus merely because of the presence of its affiliate. Professor Mikesell stated that there is growing use of in-state showrooms to help consumers decide on a purchase that is ultimately completed electronically with a remote affiliate that does not collect sales and use tax. He said that this raises two problems: (1) lost tax revenue; and (2) discrimination against in-state merchants -- typically smaller merchants -- that do not have remote affiliates.

Professor Mikesell then briefly described proposals concerning taxation of electronic commerce that are being considered in the United States Congress:

> (1) The proposed Internet Tax Elimination Act, which would have eliminated sales and use tax on transactions that use the Internet or other electronic communication. However, this bill has died.
>
> (2) The New Economy Tax Simplification Act, which would codify the physical presence rule as the nexus standard.
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> (3) The Internet Tax Moratorium and Equity Act, which would: (a) require registration by remote sellers; (b) prohibit different local sales tax rates within a state; and (c) require states to cooperate on a number of issues.

Professor Mikesell then testified concerning the simplification proposals from the National Governors Association. He said that a problem with sales tax simplification is that states currently differ on what is exempt from sales tax and what is taxable, and that simplification might require some states to change their sales tax laws considerably.

Senator Borst commented that the more serious problem is not which items are exempt, but which purchasers are exempt.

Representative Bauer questioned Professor Mikesell concerning his prediction that the state may lose as much as $325 million per year. Professor Mikesell explained that this figure was based on a study by William Fox of Tennessee, and he briefly described the methodology of the study. Representative Bauer then asked Professor Mikesell about uncollected sales and use tax revenue from catalogue sales. Professor Mikesell responded that the lost revenue from catalogue sales is currently higher than the lost revenue attributable to Internet sales. He noted, however, that the lost revenue from catalogue sales will not grow as quickly as the lost revenue from Internet sales.

Representative Bauer then recognized Mr. Grant Monahan of the Indiana Retail Council. Mr. Monahan stated that Internet sales are growing rapidly, and that by 2005 as much as 20% of transactions may be made by a remote seller. Mr. Monahan urged the Commission and the General Assembly to support the NGA / NCSL model legislation concerning sales tax simplification.

II. Property Tax Exemptions for Raw Materials

Representative Bauer then recognized Representative Sheila Klinker. Representative Klinker explained to the Commission that during the past legislative session she had introduced HB 1386, which would have provided a property tax exemption for raw materials and parts that are to be incorporated into goods that will be shipped out of state. She noted that as the bill moved through the legislative process, it was amended to apply only to Tippecanoe County. Representative Klinker stated that when designing a property tax exemption for raw materials, it is important to remember concerns about potential property tax shifts. She then thanked the Commission for considering the concept.

Representative Bauer next recognized Mr. Mike Brooks of Greater Lafayette Progress. Mr. Brooks stated that Tippecanoe County has the sixth highest inventory tax burden in the state. He commented that local manufacturers cite the inventory tax as the most important issue they face. He stated that he supports the proposed exemption, and that it is an expansion of the current exemption for finished goods to be shipped out of state.

The Commission then heard testimony from Mr. Jimmy Kesterson, representing Caterpillar Corporation. Mr. Kesterson stated that Caterpillar's Lafayette Engine Center pays over $1.5 million in inventory taxes, even though 99% of its product is eventually shipped out of state. He said that if the Lafayette Engine Center were in Illinois, its property tax liability would be reduced by 93%. Senator Vi Simpson questioned him concerning whether this savings included both real and personal property taxes. Mr. Kesterson then distributed to the Commission a description of the inventory taxes paid by the Lafayette Engine Center. (See Exhibit E, "Caterpillar - Lafayette Engine Center Inventory Tax Implications;" and Exhibit F, "Indiana Property Tax Impact on Caterpillar.") He noted that $27 million of the Center's inventory was exempt, because it was ready to be shipped out of state, but that $59 million of work in progress was taxable, even though Caterpillar knew where it would be shipped out of state, and that an additional $31 million in inventory was also taxable, even though 99% of the finished product would eventually be shipped out of state.

Representative Bauer then recognized Mr. Bill Conyan and Mr. Steve Witte of the Indiana Economic Development Association (IEDA). Mr. Conyan stated that the IEDA supports elimination of the inventory tax because of its impact on manufacturers. He said that this impact is especially hard on "second-tier" manufacturers that ship products to other manufacturers. Mr. Witte agreed with Mr. Conyan's testimony, and he gave a number of examples of Indiana manufacturers that supply goods to other manufacturers, rather than producing finished goods.

Representative Bauer then recognized Mr. Mark Cahoon of the Indiana Manufacturers Association (IMA). Mr. Cahoon distributed to the Commission a portion of the Final Report of the Indiana Fair Market Value Study (see Exhibit G). He noted that the study showed that Indiana is one of only ten states that tax inventory. He stated that some nearby states are phasing out their inventory tax. Mr. Cahoon stated that the IMA is in favor of completely eliminating the inventory tax, and that providing an exemption for raw materials that will be part of a finished good shipped out of state is a step forward.

Kevin Brinegar of the Indiana Chamber of Commerce was then recognized by Representative Bauer. He stated that the Chamber was also in favor of completely eliminating the inventory tax. Mr. Brinegar distributed to the Commission a letter from Joseph E. Seagrams and Sons, Inc., describing how its product is subject to property taxation as it matures in barrels at its Indiana distillery, even though more than 96% of the final product is shipped out of state. (See Exhibit H.)

Representative Bauer recognized Mr. Tom Fellrath of the St. Joseph County Chamber of Commerce, who spoke in favor of the proposal to exempt raw materials used in products to be shipped out of state.

Senator Ron Alting was then recognized by Representative Bauer. Senator Alting stated that the proposed exemption would be beneficial to economic development and job creation and retention. Senator Alting commented that the proposal should be implemented on a state-wide basis, and not just in Tippecanoe County.

Representative Bauer then recognized David Bottorff of the Association of Indiana Counties (AIC). Mr. Bottorff stated that he merely wished to remind the Commission that a property tax exemption for raw materials would shift the tax burden onto other taxpayers. Senator Borst commented that in the past he had introduced a bill to provide for a local option inventory tax elimination, and he asked Mr. Bottorff if the AIC could support such a measure. Mr. Bottorff responded that, because of the local option feature, he thought the AIC could support the concept.

III. Annual Adjustments to Assessed Values

Representative Bauer then called on Mr. Tim Brooks, Chairman of the State Board of Tax Commissioners, for testimony concerning annual adjustments to assessed values of property. Mr. Brooks distributed a paper to the Commission outlining positive aspects and negative aspects of annual reassessment. (See Exhibit I, "Some Pros and Cons of Annual Reassessment.") He stated that the State Board supports the concept of annual adjustments to assessed values. Mr. Brooks said that such annual adjustments would lead to greater equity in assessments, because changes to assessments could be made annually instead of once every four years. He stated that one negative aspect of annual adjustment would be the administrative costs involved.

Representative Bauer asked Mr. Brooks if he had an estimate of the cost of carrying out annual adjustments. Mr. Brooks answered that if the adjustments were done by applying new value factors to existing values, it would be fairly low, but that it would be very expensive if the adjustments involved actual physical inspections of property. Representative Lawrence Buell asked Mr. Brooks if local assessors had the computer technology to perform annual adjustments. Mr. Brooks answered that not all assessors are currently equipped to make such adjustments, and that it would take time to implement such a program.

Senator Borst commented that before going to annual adjustments, assessors must have standardized computer software. He stated that if the State Board were to put together a plan for standardized hardware and software for assessors, he would work in the General Assembly to find state funding to assist the local units with the costs.

Representative Bauer then recognized Ms. Judy Sharp, Monroe County Assessor and President of the County Assessors Association. She stated that she was in favor of implementing annual adjustments, but that her biggest concern was with the software that would be necessary for such a system. She said that under such a system there would not be a need for annual physical inspection of property, and that perhaps an inflation factor could be used to adjust the assessed values. (See Exhibit J, a copy of Ms. Sharp's written testimony.)

Representative Bauer then recognized Mr. Paul Ricketts, Lawrence Township (Marion County) Assessor. Mr. Ricketts said that he was not opposed to the concept of annual adjustments. He said that he had concerns on a number of elements that would be used in such a system: (a) the accuracy of the information on sales disclosure forms; (b) the definition of "arm's length transaction" that would be used; and (c) the cost tables that would be used.

IV. Implementation of P.L.6-1997

Mr. Brooks of the State Board of Tax Commissioners was then recognized for a discussion of P.L.6-1997 (HEA 1783) and the conversion of assessed values to 100% of true tax value. Mr. Brooks began by explaining that P.L.6-1997 provided that, effective March 1, 2001, assessed values would no longer be equal to one-third of true tax values, but would instead be equal to 100% of true tax values.

Mr. Brooks stated that the conversion to 100% of true tax value was originally timed to coincide with the reassessment. According to Mr. Brooks, when the reassessment was delayed the State Board decided to proceed with the conversion. He noted that one reason why the State Board decided to proceed was to avoid the confusion that would result if taxpayers were required to compare assessed values after the reassessment to assessed values from before the reassessment and the conversion. Mr. Brooks commented that such a comparison would make it difficult for taxpayers to understand what changes in assessed values were due to the conversion to 100% of true tax value and what changes were due to the reassessment. He noted that the State Board is working with local officials and the Association of Indiana Counties in order to implement the conversion.

Senator Borst and Senator Simpson questioned Mr. Brooks concerning whether there would be state-wide public education concerning the conversion. Mr. Brooks responded that the State Board is considering an insert to be sent with the tax bills that use the converted assessed values. Representative Bauer stressed that some type of public education effort is important, because taxpayers might otherwise see the converted assessed values and file appeals without understanding what has happened. (See Exhibit K, State Board of Tax Commissioners' "Report to the Commission on State Tax and Financing Policy.")

Representative Bauer again recognized Ms. Judy Sharp, Monroe County Assessor and President of the County Assessors Association. Ms. Sharp commented that county assessors are already preparing for 2001 (pay 2002) property taxes, but that they are still using the old, unconverted assessed values. She said that a survey of county assessors showed that most would rather have the conversion of assessed values delayed so that it would coincide with the reassessment, and she noted that county auditors and treasurers are also concerned about the conversion.

Ms. Sharp stated that the conversion to 100% of true tax value will require major software changes and a great deal of programming time for counties. She noted that county auditors would be affected by the changes even sooner than county assessors. Ms. Sharp stated that it is too late for the General Assembly to change the effective date of the assessed value conversion, so the County Assessors Association is moving ahead with the implementation.

Representative Bauer again recognized Mr. Paul Ricketts, Lawrence Township (Marion County) Assessor. Mr. Ricketts stated that a majority of township assessors wish to delay the conversion until the reassessment. He explained that because assessors are not required to send a notice to taxpayers in 2001 notifying them of the assessed value conversion, the first notice taxpayers will receive will be the Spring 2002 bill. He pointed out that under existing law, in the absence of a formal notice from an assessing official, a tax bill serves as a notice of a change in an assessment, and this would allow a taxpayer to appeal. He said that even with a public education program, many taxpayers will file appeals after they first see their converted assessed values. Mr. Ricketts stated that the converted assessed values would also require a great deal of work to recalculate the homestead credits for partial homesteads. (See Exhibit L, a copy of Mr. Ricketts' written testimony.)

Representative Bauer thanked the Commission members and the witnesses for their participation. He then adjourned the meeting.